GERRISH'S MUSINGS

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Dear Subscriber:

Greetings from Minnesota, Illinois, Missouri, Arkansas, and New York!

COMMUNITY BANK WEBSITE

I was recently preparing for a conference call with a board of directors of a community bank and decided to explore their website. It was very well done and very reflective of the community. It had pictures of workers at work, customers at work, customers at play, and bank employees. It gave a very focused picture of the bank's support for the community. Nicely done.

CREDIT UNION ACQUISITIONS AND TAXATION ISSUES

Community bankers and their lobbying groups have long argued for taxation of credit unions. Thus far these arguments have fallen on deaf ears. Much to the chagrin of community bankers, credit unions continue to enjoy their tax advantaged status when compared to community banks. The recent wave of credit unions acquiring community banks further irritates us on this particular point.

The most recently announced credit union acquisition of a community bank is happening in Florida. Del Ray Beach, Florida-based IBM Southeast Employees Credit Union is buying Vero Beach, Florida-based Oculina Bank. What really irks us about this acquisition, like the numerous other acquisitions where credit union acquirers are purchasing community banks, is the fact that the community bank's business activities are going to be exactly the same both before and after the transaction, with the exception that after the transaction these activities are no longer subject to taxation.

Oculina Bancorp, which was the target bank holding company in this transaction, is a C corporation that made approximately $1,800,000 in the first six months of 2018. As a C corporation, this income is subject to federal and state taxation. Once IBM Southeast Employees Credit Union buys Oculina, this exact same income - created by the exact same deposit and loan relationships, non-interest income, business activities and the like - will be completely free from taxation. Simply as a result of the acquisition, these exact same business activities will now somehow magically have some justification that they should be tax-free. It seems totally inappropriate to us.

CREDIT UNIONS PART 2

It is a little known fact that our firm actually did the first bank/credit union transaction. It was not a whole bank acquisition (those are of a more recent vintage); it was a branch acquisition. I still recall when the community bank client came to me and asked if there was any reason they could not sell a branch to a credit union. I told him there was no reason they couldn't, it had just never been done before. We figured out how to do it. What I still remember after all these years is that the credit union way overpaid for the branch. In fact, it may have been the highest purchase price for a branch transaction in the history of community banking. So not only don't credit unions pay taxes, they also do not have any true profitability motive, other than to keep in business. Now when we are engaged to find a buyer for a community bank (which has become more frequent lately) we always include credit unions, particularly larger ones, on the potential buyers list. Notwithstanding the philosophical differences community bankers have with credit unions on fundamental fairness (i.e. taxation) their cash is still as "green" as any other purchasers.

"MICROBANK" ACQUISITIONS

As we have relayed in previous *Musings*, there is a significant amount of interest in "microbank" acquisitions. What is a microbank acquisition, you ask? We view a microbank acquisition as an acquisition where the acquirer simply wants the platform of a bank charter instead of having any type of real interest in the target bank's legacy operations.

There is no strict definition for microbank acquisitions. In our experience, we view them as acquisitions where the target bank has $100 million or less in total assets. We have recently been approached by numerous potential acquirers that are looking for banks of this size. Frankly, it is not because the acquirers believe the target bank has existing operations that will give them a significant return on investment. Instead, it is a cheap acquisition of a bank charter, which gives them quick and efficient access to engage in a business plan they have developed.

We are currently seeing real interest in microbank acquisitions, so much to the point that we are creating an internal database of microbank buyers and sellers. This is an active space right now. However, many microbank acquisitions are still having a hard time getting completed. The biggest roadblock is the receipt of regulatory approvals when the acquirer essentially wants to buy the target bank's charter, leave its existing operations as a separate line of business, and then totally change the core business on a going forward basis.

ACQUISITION DEBT

We are currently working a number of different merger and acquisition transactions in our firm. In some of these deals we are representing buyers, and in others we are representing sellers. One of the themes that has risen to the top in these transactions is the use of acquisition debt. It is becoming more and more common for these transactions to incorporate some type of debt component. This was not the case five or so years ago, but is the case now because the market is much more willing to loan to bank holding companies to complete these types of transactions.

One of the questions that often comes up in these types of transactions is how much debt an acquirer can use. The Small Bank Holding Company Policy Statement provides some guidance in this area. The general rule is that the amount of acquisition debt should not exceed 75% of the purchase price of the target. The Small Bank Holding Company Policy Statement also provides that a bank holding company's debt to equity ratio should not exceed 100%.

While the Small Bank Holding Company Policy Statement specifically lists these as the "maximums" in an acquisition transaction, in our experience the Fed's squeal factor is actually a little bit lower. Our general experience is that the Fed really looks closely at an acquisition where more than 50% of the purchase price is funded with new debt or the holding company's debt to equity ratio at the close of the transaction is 70% or more. These are not absolutes, but they are a good guideline to follow.

If you are thinking about engaging in a transaction where debt is going to fund part of the purchase price, keep these in mind. You do not want to find yourself in a position where you think you can get regulatory approval for a transaction and ultimately you cannot.

THE FUTURE OF MUTUALS

We recently received an interesting request from the president of one of our mutual community bank clients. This individual was asked to speak on a panel concerning the future of mutuals at a mutual banking conference. In preparation, the client asked if we would provide our thoughts concerning the future of mutual community banks.

Our response was pretty straightforward – we think the future for mutual community banks is pretty strong. We do not view the actual operating environment for mutual community banks to be significantly different than the operating environment for stock-owned community banks. We think both will present plenty of opportunities to make money and continue as an independent entity, if that is the board's desire. The major difference that we see between mutuals and stock-owned community banks is the fact that mutuals do not have shareholders that are going to be judging independence based on the board's ability to enhance the value of their investment. Frankly, this is a benefit that the directors and officers of mutuals enjoy. Pure mutual institutions do not have shareholders that have made actual financial investments into the company, so they do not have the pressures of making strategic decisions based on how it will affect the shareholders. Certainly they make decisions based on how the members will be impacted, but individual financial considerations of the members are not present.

Overall, we see the future for both mutual and stock-owned community banks as being strong. The only difference we see between the two is the fact that mutuals will have a little more leeway and freedom resulting from the lack of pressure to react to shareholder needs.

OWNERSHIP DILUTION

We were recently visiting with a very closely-held client to discuss the acquisition of a bank about half their size. This will be an easy transaction for them to complete. Our firm ran the numbers through our merger model, and everything looked great. The transaction did require a fair amount of leverage (less than 50% debt to equity ratio), so we had two questions for the board of directors. First, is the Board comfortable with holding company leverage? Second, if it is not, is the ownership family comfortable with the sale of stock to new investors? Both of these are not only financial issues, but philosophical issues. We have been with many boards who have never leveraged their holding company (even though that is one of its primary purposes), and we have been with some ownership families who refuse to dilute their ownership (even from 100% down to something that is still a control position).

Before you move forward in the acquisition arena, these discussions need to be held at the board level and/or at the control shareholder level. To do a community bank acquisition, most of which these days are for cash, cash has to be generated from someplace. That is either debt or the sale of equity. There are ramifications to each one, and the board and ownership need to understand the advantages and disadvantages of each.

THE INDEPENDENCE STRUGGLE

One of the most difficult decisions a community bank or bank holding company board has to make is whether the bank should remain independent. As most *Musings* readers know, we are staunchly in favor of independent community banks, although we also realize that a variety of different circumstances will prompt the sale or merger of some community institutions. We have recently been with several boards who have really struggled with what is the best thing to do, particularly in this consolidating environment where prices are back up into the high/reasonable level. Most boards start the process as they should, by questioning "what is in the best interest of our shareholders." If the board's answer is that holding onto our stock is better for our shareholders than any likely cash or stock from a potential acquiror, then the independence direction is set. If it cannot answer in that way, for a variety of reasons - lack of management succession, lack of share liquidity, lack of cash flow coming off the stock, lack of growth in earnings, etc. - then they may need to further analyze whether independence is the right proactive strategy for the community bank. Not an easy decision in any circumstances.

CONCLUSION

The first of August is right around the corner. Most school systems (at least in the south) are preparing to accept students for the coming year. Be careful as these kids are out and about getting ready to go to school (while their minds are still on summer vacation).

Have a great two weeks.

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